FILE COPY

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1959.

No. ~~229~~. 42

SMALL BUSINESS ADMINISTRATION,
Petitioner,

vs.

G. M. McCLELLAN, Trustee,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS, TENTH CIRCUIT.

BRIEF FOR RESPONDENT IN OPPOSITION.

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OCTOBER TERM, 1959.

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OPINIONS BELOW.

This proceeding originated in bankruptcy in the United States District Court for the District of Kansas. The first decision was made by the Honorable E. R. Sloan, Referee in Bankruptcy. That opinion is unreported, but is contained in the record at pages 35 through 38. A petition for review was filed. The opinion of the United States

District Court for the District of Kansas on the petition for review is reported at 168 F. Supp. 483, and appears in the record at pages 40 through 46. An appeal was taken to the United States Court of Appeals for the Tenth Circuit. The opinion of the Court of Appeals is reported in 272 F.2d 143.

JURISDICTION.

The jurisdiction of this court is invoked under 28 U.S.C. 1254 (1). The jurisdictional requisites are set forth in the petition.

STATUTES INVOLVED.

The statutes involved are:

1. Section 64, Fifth (11 U.S.C. § 104 (5)) of the Bankruptcy Act providing a priority of the Fifth Class to "debts owing to any person, including the United States, who by the laws of the United States is entitled to priority, * * *";

2. R.S. § 3466 (31 U.S.C. § 191) which provides, "whenever any person indebted to the United States is insolvent, * * * the debt due to the United States shall be first satisfied; * * *"; and,

3. The Small Business Act of 1953, as amended, 15 U.S.C. §§ 631-651, which was in effect at the time of the commencement of this litigation, particularly 15 U.S.C. § 631 (a), which provides:

> "The essence of the American economic system of private enterprise is free competition. Only through full and free competition can free markets, free entry into business and opportunities for the expression and

growth of personal initiative and individual judgment be assured. The preservation and expansion of such competition is basic not only to the economic well-being but to the security of this Nation. Such security and well-being cannot be realized unless the actual and potential capacity of small business is encouraged and developed. It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect insofar as is possible the interests of small business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts for supplies and services for the Government be placed with the small-business enterprises, and to maintain and strengthen the overall economy of the Nation."

and 15 U.S.C. 636 (a) (1):

"(a) The Administration is empowered to make loans to enable small-business concerns to finance plant construction, conversion, or expansion, including the acquisition of land; or to finance the acquisition of equipment, facilities, machinery, supplies, or materials; or to supply such concerns with working capital to be used in the manufacture of articles, equipment, supplies, or materials for war, defense, or essential civilian production or as may be necessary to insure a well-balanced national economy; and such loans may be made or effected either directly or in cooperation with banks or other lending institutions through agreements to participate on an immediate or deferred basis: *Provided, however,* That the foregoing powers shall be subject to the following restrictions and limitations:

"(1) No financial assistance shall be extended pursuant to (a) above unless the financial assistance applied for is not otherwise available on reasonable terms and *all loans made shall be of such sound value or so secured as reasonably to assure repayment;* no immediate participation may be

purchased unless it is shown that a deferred participation is not available; and no loan may be made unless it is shown that a participation is not available."

(The Small Business Act of 1953 was re-enacted in 1958, 72 Stat. 384, 15 U.S.C. §§ 631-651. The provisions of the 1958 act are virtually identical with the provisions of the 1953 act. The language emphasized in 15 U.S.C. 636 (a) (1) above now appears as a separate sub-paragraph, 15 U.S.C. § 636 (a) (7) in the 1958 Act.)

QUESTION PRESENTED.

The question for determination is whether or not the Small Business Administration, under the facts of this particular case and under the Small Business Act of 1953 is entitled to a priority as to seventy-five per cent (75%) of the unpaid portion of a note executed by the bankrupt to the Brookville State Bank.

The question was raised by the Trustee's objection to the allowance of the SBA claim as a priority claim on four grounds:

1. That the act creating the Small Business Administration created a separate and distinct entity which was not invested with the sovereign privileges and immunities of the United States.

2. That this claim was assigned to the Small Business Administration after the date of bankruptcy or insolvency and therefore is not entitled to priority.

3. That the allowance of the priority would be inconsistent with the Small Business Act of 1953, and with other statutes and other acts of Congress.

4. That the allowance of the priority would be inconsistent with the purpose for which the priority was granted.

STATEMENT.

On November 19, 1956, the Small Business Administration and the Brookville State Bank, Brookville, Kansas, entered into a participation agreement between themselves (Exhibit "A", R. 5-10). This agreement recites that S. H. Byquist, d/b/a Western Distributors, "has made application for a loan in the amount of $20,000.00" and "SBA desires to purchase a participation of 75% of the loan or such part thereof as bank may disburse to borrower." (Exhibit "A", R. 5).

By the participation agreement, the Small Business Administration agreed that upon written demand by the bank, it would purchase from the bank a participation of 75% of each disbursement made by the bank (Exhibit "A", ¶ 2, R. 6). It was further agreed that the bank and SBA would share ratably in accordance with their respective interests in the loan any income (Exhibit "A", ¶ 12, R. 9), expenses (Exhibit "A", ¶ 13, R. 9), or losses (Exhibit "A", ¶ 14, R. 10).

The Brookville State Bank did lend S. H. Byquist, d/b/a Western Distributors, $20,000.00. Said loan was evidenced by a promissory note dated November 16, 1956, payable to the order of the Brookville State Bank, Brookville, Kansas (Exhibit "B", R. 10-14). The bank, pursuant to the provisions of paragraph 2 of the participation agreement, made written demand on SBA for purchase of 75% of the disbursement (Exhibit "F", R. 29). Pursuant to the participation agreement and this demand, SBA

sent a check for $15,000.00, dated November 23, 1956, to the bank (Exhibit "C", R. 16), for purchase of its participation in the loan to Byquist.

On September 5, 1957, S. H. Byquist, an individual, d/b/a Western Distributors, was adjudicated a bankrupt (R. 34).

Subsequent to the institution of the bankruptcy proceedings and the adjudication in bankruptcy, the Brookville State Bank assigned the note to Small Business Administration (R. 34).

On October 15, 1957, Small Business Administration duly filed a proof of claim in bankruptcy for the full unpaid balance of the note (R. 3-5).

On November 22, 1957, after all due credits were given, there remained due on said $20,000.00 note the sum of $16,355.69, with interest paid to the date of bankruptcy (R. 34).

The total gross estate in the hands of the Trustee is approximately $19,000.00, against which claims totaling $43,682.07 have been filed (R. 34).

The Trustee duly filed objection to the allowance of the SBA claim as a priority claim on the grounds that the SBA was created as a separate entity and was not invested with the sovereign privileges and immunities of the United States (*Sloan Shipyards Corporation* v. *United States Shipping Board*, 258 U.S. 549, 66 L. Ed. 762; *RFC* v. *J. H. Menihan Corp.*, 312 U.S. 81, 85 L. Ed. 595; *Nathanson* v. *National Labor Relations Board*, 344 U.S. 25, 97 L. Ed. 23); that the assignment of this claim occurred after the date of bankruptcy or insolvency and no debt was due to the Small Business Administration at the date of bankruptcy (*United States* v. *Marxen*, 307 U.S. 200, 83 L. Ed.

1222); that the allowance of the priority would be inconsistent with the Small Business Act of 1953, and other statutes and acts of Congress (*United States* v. *Guaranty Trust Company*, 280 U.S. 478, 74 L. Ed. 556; *National Bank* v. *United States*, 107 U.S. 445, 27 L. Ed. 537; *Davis* v. *Pringle*, 268 U.S. 315, 69 L. Ed. 974); and, that the allowance of the priority would be inconsistent with the purpose for which the priority was granted (*Nathanson* v. *National Labor Relations Board*, 344 U.S. 25, 97 L. Ed. 23; *United States* v. *Marxen*, 307 U.S. 200, 83 L. Ed. 1222).

The Referee denied priority on the ground that the SBA is a separate entity (R. 35-38). The District Court denied priority on the ground that there was a post bankruptcy assignment (168 F. Supp. 483, R. 40-46). The Court of Appeals held the determining fact to be:

> "* * * that SBA has by written contract with the Bank agreed to share ratably the proceeds and losses resulting from the transaction with Byquist.
>
> "Marxen holds that absent controlling legislation, which is not present here, § 3466 grants priority only to the United States. In *Nathanson* v. *National Relations Board*, 34 U.S. 25, 28, it was said that § 3466 may not be extended to create a priority for a claim which the United States is collecting for a private party. This principle would be violated if the claim of the United States were here given priority.
>
> "The United States is bound by its written contract to account to the Bank for the Bank's 25% share of any collection made under the note. Hence, the Bank would share to that extent in any proceeds resulting from the award of a priority to the United States. No such priority in a private creditor is provided by § 3466.
>
> "The Bankruptcy Act is intended to bring about an equitable distribution of the bankrupt's estate

among creditors holding just demands. The use of § 3466 to prefer the Bank over other private creditors would defeat that intent.

"The United States has engaged in a commercial enterprise and made no effort to safeguard its rights under § 3466. In a contract made on its own forms it has agreed to share ratably proceeds and losses. It may not assert a priority which will produce a recovery that by contract must be divided with a private entity." (272 F.2d 143, 145, 146, Petition, Appendix, pp. 27-28).

ARGUMENT.

The facts on which this case was decided were stipulated. On those facts, and the Small Business Act of 1953, the decision of the court below is manifestly correct. There are no questions of importance involved in the decision of this case which have not been previously determined by this court. The Court of Appeals, and the District Court, decided the case on settled principles of law as enunciated by the former decisions of this court. The decision is not in conflict with any decision from any other Court of Appeals. No purpose would be served by granting the writ of certiorari in this case.

The reasons advanced by petitioner for granting the writ of certiorari are not based upon the issues of this case, nor upon any facts in the record in this case, or of which the court may take judicial notice; but rather upon selected statistical information in petitioner's own files, and supported only by quotation of communications from petitioner to its attorneys (See, *e. g.* Petition, p. 15, n. 11; p. 16, n. 12).

The burden of petitioner's argument is that "the decision below will have far reaching and severe detrimental

effects on extensive government lending activities, * * *" (Petition 9). This, in turn, is based on the proposition that "the question of priority is of particular significance, since SBA business loans, because of statutory prerequisites as to their availability, are primarily extended to concerns whose insolvency is not unlikely." (Petition 15). This argument is inappropriate and inapplicable to the facts and law under which this case was decided. The statutory mandate of the Small Business Act of 1953 at the time this loan was made and at the time this litigation commenced was that "all loans made shall be of such sound value or so secured as reasonably to assure repayment." (Small Business Act of 1953, § 207 (a) 1, 15 U.S.C. § 636 (a) 1. See, 1958 Act, 15 U.S.C. § 636 (a) (7)). The intention to rely on other means than the priority provided by § 3466 for obtaining repayment of these loans is clear from the Act.

The Decision Below Is Correct.

SBA has filed a claim against the bankrupt in the sum of $16,788.42. (It was subsequently stipulated that the correct figure after all credits were given was $16,355.69 (R. 34).) This claim is based on a note given by the bankrupt to the Brookville State Bank, and a participation agreement entered into between the Bank and Small Business Administration. In a partial recognition of the participation agreement, SBA has, from the outset, asserted priority only for 75% of the total claim, or $12,266.75.

In this case, if no priorities are allowed, all of the creditors will receive a dividend of approximately 30%. If the priority claimed by SBA were allowed, the greatest dividend the common creditors could expect to receive would be approximately 2% if in fact they received any dividend at all.

Under the participation agreement, it is provided that "loss shall be borne ratably by SBA and Bank in accordance with their respective interests in the loan." (R. 10). If the priority should be allowed as to $12,266.77 of this $16,355.69 claim, and the balance be allowed as a common claim, there would be a total recovery on the claim of $12,348.53, assuming a 2% dividend on the balance. Under the participation agreement on which SBA bases its claim, $3,087.13 of this amount would be payable to the Brookville State Bank.

The Brookville State Bank would therefore receive from the assets of the bankrupt approximately 75% of its claim, while the other common creditors receive only 2%. The Bank, as a common creditor with no superior equities, would thus be preferred over the other common creditors contrary to the purpose of the Bankruptcy Act to bring about an equitable distribution of the bankrupt's estate among creditors holding just demands. The SBA, on the other hand, would not enjoy the fruits of the priority since under the participation agreement it could not retain the amonut for which the priority was allowed.

By the same reasoning by which SBA initially claimed priority to only a $12,266.77, it might claim priority to only $9,261.40, the amount it would be entitled to retain under the distribution set out above. Here, again, however, while the dividend to the common creditors would be somewhat increased, the recovery by SBA by virtue of its priority would have to be shared with the Bank under the participation agreement. This again would result in an inequitable preference of the Bank, and SBA would not retain the amount recovered by virtue of the priority.

The only point at which a dividend can be allowed on this claim without resulting in a sharing by SBA and a

preference to the Bank, thus satisfying and enforcing the provisions of both the participation agreement and the Bankruptcy Act, is by allowance of the claim as a common claim without priority. At that point, and at that point only, the Bank and SBA will share ratably, according to their respective interests in the loan, the loss sustained on this loan, so that no amount will be due by either to the other, and no inequitable preference will result to the Bank.

Insofar as any amount is recovered by the Small Business Administration in excess of an ordinary dividend, a part of that excess must be divided with the Bank. So much of the recovery as must, under the participation agreement, go to the Bank, is not a debt due the United States. The collection of that amount by the Small Business Administration is for the benefit of a private party.

In *United States* v. *Marxen*, 307 U.S. 200, 83 L. Ed. 1222, this court after announcing the principle that § 3466 is to be construed liberally to effectuate its purpose to protect the public revenues said:

> "But this principle of construction is subject to the limitation that the generality of the language of the section is restricted by the purpose to grant priority to the United States, only, and by legislative intention, as shown by other statutes."

In *Nathanson* v. *National Labor Relations Board*, 344 U.S. 25, 97 L. Ed. 23, it was said that § 3466 may not be extended to create a priority for a claim which the United States is collecting for the benefit of a private party.

On the authority of those cases, and a finding that the allowance of a priority in this case would defeat the intent of the Bankruptcy Act to bring about an equitable

distribution of the bankrupt's estate among creditors holding just demands, the Court of Appeals denied priority.

The petitioner attempts to distinguish the Nathanson case on the ground that whereas in that case the entire amount collected would be paid over to private parties, here, a part of the recovery would be retained by the SBA. It also takes the position that the participation agreement between it and the Bank upon which it bases its claim is some side agreement which cannot be considered in the bankruptcy proceeding. The petitioner says:

> "This independent agreement between the SBA and the Bank, providing for the sharing of proceeds and losses, cannot properly be considered with respect to the question of whether the SBA's claim is entitled to statutory priority in the bankruptcy proceeding." (Petition 12).

The SBA has here filed a claim for $16,788.42, of which it concededly is entitled only to a part. To prove that part of the claim which belongs to it, the SBA alleged and proved an agreement with the Brookville State Bank by which it agreed to purchase from the Bank a participation of 75% of each disbursement made by the Bank, and also, that proceeds and losses would be shared in accordance with the respective interests in the loan. This is a single indivisible agreement between SBA and the Bank. It must be read and construed as a whole. The provisions relating to the sharing of proceeds and losses is as much a part of the agreement as the agreement to purchase a participation of the loan initially.

This is no side agreement or independent contractual undertaking. It is the very basis for the determination of the allowance of this claim; the parties entitled to any recovery allowed on the claim; and, whether or not those

parties or either of them are entitled to a priority and to what extent.

Under the Small Business Act of 1953, the SBA had a complete right to enter into the agreement which it made with the Bank; it has the duty to fulfill that obligation. It can only fulfill that obligation in this transaction, and under this agreement, by "bearing the loss" as provided in the agreement. The reimbursement to the Bank must come from the assets of the bankrupt. We submit that the SBA has no right, power or authority to make any reimbursement to the Bank by way of gift, donation or payment to the bank to fulfill the obligation it has undertaken regarding losses in its participation agreement. It can bear the loss; it cannot recover and repay as some side agreement.

The Small Business Act provides for the participation by the Small Business Administration with ordinary commercial banks and other lending institutions. By such participation any claim which might be made by Small Business Administration is so affected by a private non-governmental interest that the allowance of any priority would be inequitable and inconsistent with the purpose of the Small Business Act, the Bankruptcy Act, and inconsistent with the purpose of § 3466 itself.

The Court of Appeals, in its opinion in this case, said:

> "The United States has engaged in a commercial enterprise and made no effort to safeguard its rights under § 3466. In a contract made on its own forms it has agreed to share ratably proceeds and losses. It may not assert a priority which will produce a recovery that by contract must be divided with a private entity."

There is nothing new in this principle. As early as 1824, in *Bank of the United States* v. *Planters Bank*, 9 Wheat

904, 6 L. Ed. 244, this court, in an opinion delivered by Mr. Chief Justice Marshall, said:

> "It is, we think, a sound principle, that when a government becomes a partner in any trading company, it divests itself, so far as concerns the transactions of that company, of its sovereign character, and takes that of a private citizen. Instead of communicating to the company its privileges and its prerogatives, it descends to a level with those with whom it associates itself, and takes the character which belongs to its associates, and to the business which is to be transacted. * * *"

Here the SBA has in effect entered into a partnership or joint venture with an ordinary commercial bank. The interests of the SBA and the Bank in this transaction are inseparable. Any action which affects one of the parties, of necessity, affects the other.

> "The broad purpose of the bankruptcy act is to bring about an equitable distribution of the bankrupt's estate among creditors holding just demands * * *."
> *Kothe* v. *R. C. Taylor Trust*, 280 U.S. 224, 227, 74 L. Ed. 382.

> "The theme of the Bankruptcy Act is 'equality of distribution' (*Sampsell* v. *Emperial Paper & Color Corp.*, 313 U.S. 215, 219, 85 L. Ed. 1293, 1298, 61 S. Ct. 904); and if one claimant is to be preferred over others, the purpose should be clear from the statute."
> *Nathanson* v. *National Labor Relations Board*, 344 U.S. 25, 29, 97 L. Ed. 23, 29.

It is the duty of the court and the trustee to see that the intent and purpose of the Bankruptcy Act is carried out. That has been done in this case.

In addition to the reasons stated by the Court of Appeals, the decision is also correct under the decision of this court in *United States* v. *Marxen*, 307 U.S. 200, 83 L.

Ed. 1222, which was the basis of the decision of the District Court in this case.

In the instant case the note which is the basis of this claim was assigned to the SBA subsequent to the adjudication in bankruptcy. This fact was stipulated (R. 34), and is acknowledged in the Statement in the Petition here (Petition 6).

The Marxen case was on a certified question:

> "Where, prior to the filing of a petition for an adjudication in bankruptcy of the maker of a promissory note payable to a bank, the Federal Housing Administrator, under the provisions of the National Housing Act, insured the payee bank against the nonpayment of the note by its maker, upon which note the maker became in default more than sixty days prior to said filing and adjudication, and upon demand of the insured bank made after the adjudication, the Federal Housing Administrator paid to the bank its claim arising from such default, and procured an assignment to the United States of the claim of the insured bank against the bankrupt, which claim had not been presented or proved in bankruptcy by the insured bank, and presented such claim in the name of the United States to the trustee in bankruptcy, having before him other allowed claims against the bankrupt, is such claim entitled to priority over such other claims under § 3466 of the Revised Statutes (31 U.S.C.A. § 191), by reason of the provisions of § 64 (b) (7) (11 U.S.C.A., § 104 (b) (7))?"

The court held:

> "We are of the view that §3466 is inapplicable to general claims in bankruptcy transferred to the United States, or to which it has become subrogated on payment, after the filing of the petition for the reason that the rights of creditors are fixed by the Bankruptcy Act as of the filing of the petition in bankruptcy."

In the present case there is no conflict of decisions. The court below made no innovations or inventions in deciding this case. It was determined on settled principles of law as enunciated by former decisions of this court. There are no questions of importance involved in this decision which have not been determined by this court. No purpose would be served by the granting of a writ of certiorari in this case.

Effect on Government Lending Activities.

Petitioner contends the decision below will have far reaching and severe detrimental effects on extensive government lending activities. This argument is based on the proposition that SBA business loans "are primarily extended to concerns whose insolvency is not unlikely. It argues that the decision has placed government agencies in a dilemma: Whether to alter the nature of the participation agreements to avoid the impact of the decision, a course it alleges would be highly undesirable; or to let the participation agreements remain unmodified and leave the money disbursed unprotected by any priority right. We submit that this is an argument which should be presented to the Congress and not to this court.

We also submit that the facts presented by this petition do not support the conclusion for which petitioner contends. While the petitioner sets forth total sums of money outstanding on participation loans there is no showing of losses or defaults on those loans. The importance of the question of priority rests solely upon petitioner's unsupported statement that SBA business loans are primarily extended to concerns whose insolvency is not unlikely. This statement is contrary to the provisions of the Small Business Act of 1953, and to the regulations currently in effect.

We have contended from the outset of this litigation that in the Small Business Act of 1953 Congress evidenced unmistakably its purpose to rely for obtaining payment of the government advances on other means than the priority provided for by § 3466 (*United States* v. *Guaranty Trust Company*, 280 U.S. 478, 78 L. Ed. 556).

In the *Guaranty Trust Case* the court found this purpose by virtue of the provisions of the Transportation Act by which "the giving of adequate security was either required or left to the discretion of the President"; and that "under § 210 no advance could be made, unless the Interstate Commerce Commission was satisfied that the earning power of the carrier and the security given furnished reasonable assurance that the loan would be repaid and all obligations in connection therewith would be performed."

So, in this case, the Small Business Act of 1953 provided:

> "No financial assistance shall be extended pursuant to (a) above unless the financial assistance applied for is not otherwise available on reasonable terms *and all loans made shall be of such sound value or so secured as reasonably to assure repayment*; no immediate participation may be purchased unless it is shown that a deferred participation is not available; and no loan may be made unless it is shown that a participation is not available." (Emphasis supplied) (15 U.S.C.A. 636 (a) (1)).

When the Small Business Act was re-enacted in 1958, the language emphasized above was made a separate subsection, so that 15 U.S.C. § 636 (a) now provides:

> "(7) All loans made under this subsection shall be of such sound value or so secured as reasonably to assure repayment."

Likewise, the regulations promulgated pursuant to that act provide:

> "(c) Emphasis shall be on the repayment ability of the borrower as determined from the record of past earnings.
>
> "(d) All loans shall be secured; however, the participating bank shall be responsibe for obtaining the pledge of collateral as well as determining the adequacy thereof. Security may include, but shall not be limited to, mortgage on real or personal property, assignment of accounts receivable or monies due on contracts, pledge of warehouse receipts and guaranties."
>
> 13 CFR § 120.4-. (c) (d), 23 F.R. 10513, December 31, 1958.

The reports of the SBA would indicate that these directions have been followed. During the consideration of H. R. 7963, which became public law 85-536, 72 Stat. 384, the Small Business Administration reported on its activity under the business loan program. The summary of this activity from the beginning of operation through the third quarter of fiscal year 1958 shows a total of 7,558 loans disbursed in a total amount of $336,527,024, of which SBA's share was $279,638,384. Through March 25, 1958, only 17 loans had been charged off at a loss of $166,912, of which $159,383 was principal and $7,529 was interest and other receivables. While it is also shown that on that same date 180 loans, of which SBA's share was $5,654,034, were in liquidation, a note concerning the loans in liquidation states, "It is anticipated that existing collateral will permit recovery of the greater portion of this unpaid principal balance." (These figures are tabulated in Senate Report No. 1714, June 16, 1958, to accompany H. R. 7963, under the heading Business Loans—Small Business Administration—Selected Statistics on Business Loans.)

Petitioner concludes that the decision below will seriously undermine these participation programs and will force the agencies to revise their participation agreements to avoid the decision. We submit that that is not the case. The Congress and the Small Business Administrator from the beginning of the Small Business Administration have shown the way. That is by placing emphasis upon the repayment ability of the borrower and making loans of such sound value or so secured as reasonably to assure repayment. The intent of Congress, as derived from an analysis of the Small Business Act of 1953, has never been to rely upon the priority granted to the United States for repayment of these loans.

The decision below is correct and petitioner has failed to show any special and important reasons for the court to grant a writ of certiorari in this case.

CONCLUSION.

For the foregoing reasons, it is respectfully submitted that this petition for writ of certiorari should be denied.

Respectfully submitted,

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